BOOK REVIEWS

Cross Border Collateral: Legal Risks and the Conflict of Laws, R. Potok, ed. (London, Butterworths, 2002, 659 pp., $280)

Many people still think that ownership of securities is directly evidenced by certificates held by, or registered in the name of, individual investors. That direct holding system, however, has been largely supplanted — both in North America and abroad — by an indirect holding system under which so-called securities intermediaries not only hold the securities on behalf of investors but also frequently own beneficial rights in those same securities.

A company issuing securities in the indirect holding system generally records ownership of the securities with a depository institution, such as the Canadian Depository for Securities Limited or, in the United States, The Depository Trust Company. In reality, though, these depositories act as custodial intermediaries, recording on their books and records the identities of brokerage firms, banks or other intermediaries that purchase interests in these securities. Those intermediaries in turn record on their own books and records the identities of investors, or other intermediaries, that purchase interests in the securities. The chain of intermediaries can have many links before reaching the ultimate investor.

Although physical certificates exist for most securities, these certificates generally remain in the applicable depository's possession and are not delivered to transferees. Eliminating the transfer of certificates greatly reduces administrative costs and also significantly lowers the risk of loss occasioned by physically transferring securities.

Notwithstanding these benefits, the indirect holding system has a potentially serious drawback. The sharing of ownership rights at each intermediary level — caused by the fact that an investor that purports to own, say, a specified number of shares of ABC Corporation's stock actually owns a percentage undivided, or pro rata, interest *in the interest in such shares owned by the intermediary from which the investor bought its interest*; and that intermediary itself owns only a percentage undivided interest *in the interest in the ABC shares owned by the intermediary from which it bought its* *interest*, and so forth[1] — raises a question of first impression in many legal systems: whether, in the event of an intermediary's failure, creditors of the failed intermediary can claim against securities held by the intermediary for the benefit of investors.[2] This "intermediary risk" also can be systemic: the failure of an intermediary might cause a chain reaction of failures of institutions that have invested in assets held by the intermediary. Indeed, because of the international tiering of intermediaries, such a chain reaction, if it involved an intermediary holding a large enough quantity of assets, could affect the very stability of the global financial system. Even absent systemic risk, concern over intermediary risk is exacerbated where, as is increasingly common, securities are transferred across national borders.

Intermediary risk additionally threatens the rights of lenders to securities investors. To the extent investors, as is commonplace, pledge their securities as collateral to lenders, the lenders' rights — being derivative of the investors' rights[3] — may be subject to claims of creditors of the failed intermediary. Sometimes it is prudent to retain counsel in order to advise on this risk; but because it is often unclear under existing law which jurisdiction's legal system governs, this necessitates paying counsel in multiple jurisdictions.[4]

1. For a numerical example of how this works, see Steven L. Schwarcz, "Intermediary Risk in a Global Economy" (2001), 50 Duke L.J. 1541 at p. 1548. References in this book review to "investors" will include, as applicable, intermediaries that have purchased interests in securities from other intermediaries.
2. For a detailed discussion of this risk, see Schwarcz, *ibid.* (discussing intermediary risk not only in the context of the indirect holding system for securities but also in the context of securitization transactions, sales of loans participations, and any other form of financing in which money flows through an intermediary and analyzing how intermediary risk should be resolved). Potok's book explains the origin of this concern as follows: "The concept of a direct property right becomes difficult to apply in the context of indirect holding systems. This is because under traditional legal principles commingling fungible property terminates direct property rights of owners of the individual commingled items." (Potok, at p. 21).
3. See *infra*, footnote 7 and accompanying text (explaining this derivative relationship and arguing that Potok's exclusive focus on lenders' rights appears unnecessarily limiting).
4. For those unfamiliar with conflict of laws terminology, the fact that a given jurisdiction's "law" applies does not assure that the actual substantive law of that jurisdiction will apply. That is because the term "law" can refer both to such substantive law and also to the jurisdiction's legal rules that determine whether courts should apply another jurisdiction's substantive law. The meta-law rules that determine whether courts should apply another jurisdiction's substantive law are referred to as choice of law rules. For example, say that Country X's substantive law provides that the rights of a transferee of indirectly held securities are determined according to a rule that gives an intermediary's creditors priority over an investor purchasing those securities, Country Y's substantive law provides that such rights are determined according to a rule that gives the investor priority over the intermediary's creditors, and a dispute over these rights arises where the intermediary is

Richard Potok's book, *Cross Border Collateral: Legal Risks and the Conflict of Laws*, focuses on the need to establish more clearly, under international law, which nation's legal system governs this intermediary risk in any given transfer of securities — in legal terms, a conflict of laws analysis. To this end, the book begins with a succinct but excellent overview of the problem by the famed Sir Roy Goode of Oxford University. In chapter 2, Potok, along with Christophe Bernasconi, First Secretary at the Permanent Bureau of the Hague Conference on Private International Law, and Guy Morton, a partner at a top U.K. law firm, expand the discussion of the legal nature of interests in indirectly held securities and also provide a helpful introduction to conflict of laws principles.

Chapter 3 sets forth representative fact patterns and related sets of questions that are used in the remainder of the book as templates for analyzing conflicts of laws. The next 24 chapters provide nation-specific summaries of how the conflict of laws rules of selected countries (with a chapter for each country, including Canada, written by one or more of the country's lawyers[5]) would, under the representative fact patterns of chapter 3, identify the particular legal system governing intermediary risk. The final chapter summarizes the work of the Hague Conference on Private International Law in trying to harmonize these conflict of laws rules through an international convention or treaty.[6]

The bulk of Potok's book is thus highly technical, useful mostly for lawyers who regularly have to address these conflict of laws problems for internationally traded securities. In that context, one might quibble with the selection of certain of the countries whose laws were summarized. Why does the book select Finland or New Zealand, for example, and why does it not select China (or Hong Kong) or any South American country?

Another quibble, which ostensibly though not actually limits the book's scope, is its focus on intermediary risk solely from the perspective of lenders to securities investors. This perspective is

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in country X and the investor is in country Y. The question of which country's substantive law applies would be resolved in the first instance by the choice of law rules of the country in which the dispute is litigated.

5. For example, the chapter on Canada, which is restricted to the conflict of laws rules of Ontario and Québec, was written by Bradley Crawford Q.C., Eric Gertner and Michel Deschamps.

6. The Conference's work on this convention, concluded in December 2002 but not yet in force, is summarized at <http://www.hcch.net/e/workprog/sec_sum.html#summary>.

apparently taken because investors commonly pledge their securities as collateral to lenders, lenders customarily require legal opinions on the collateral, and thus counsel giving such opinions frequently have to analyze intermediary risk from the standpoint of indirectly held securities pledged as collateral. Perhaps the book should have explained more clearly, however, that legal concerns arise less because of the pledge *per se* and more because the lenders' rights in the securities held as collateral are *derivative of the investors' rights in the collateral*. This reflects that an investor cannot pledge as collateral greater rights than it has in the first place. The fundamental legal issue is therefore not the pledge itself but, rather, the question of how the investors' underlying ownership rights in the pledged securities fare as against the rights of creditors of a failed intermediary. The only apparent recognition of this derivative relationship, however, is on a single page of the 600-plus page book.[7]

Beyond the technical level, however, the work makes an important normative contribution — though one intended more for government policy makers than for practicing lawyers. It concretely demonstrates that "the conflict of laws issues identified in Chapter 3 are addressed in many different ways" in different nations.[8] These differences arise because traditional conflict of laws rules would look to the law of the jurisdiction where the securities are located (the so-called *lex situs* rule), which is difficult to ascertain for indirectly held securities. Is it the jurisdiction, for example, where the company issuing the securities is located; or where the relevant depository is holding, in custodial capacity, the certificates evidencing the securities; or where one or more other intermediaries are located; or where the investor is located? The answer is far from obvious. For this reason, "given the legal complexity and lack of relevant court decisions, the authors of the country chapters were often unable to provide a definitive answer" to the question of which legal system applies.[9]

Because these uncertainties "lead to significant expense for all [securities] market participants",[10] reducing the uncertainties is

7. Potok, at p. 11: "The examples considered in this book focus mainly on collateral transactions .... However, there seems to be no reason to distinguish for this purpose transfers of title under collateral transactions from ordinary transfers by way of sale."
8. Potok, at p. 615.
9. *Ibid.*
10. *Ibid.*

certainly a worthwhile goal. Here again, however, the book's focus may be unnecessarily narrow. The entire focus is on harmonizing conflict of laws rules internationally, centring quite sensibly on the law of the jurisdiction where the relevant intermediary — *i.e.*, the intermediary with which the relevant investor is in privity of contract — is located.[11] This attempt to unify conflict of laws rules may well be a pragmatic first step. Indeed, it is the *only* step over which the Hague Conference on Private International Law, with which Potok has worked closely, has jurisdiction.[12] But even a uniform conflict of laws rule to which all nations of the world agree would not reduce uncertainty if the rule points to a legal system that tolerates intermediary risk.[13]

To understand this limitation, compare the book's conflict of laws approach — focusing, for purposes of comparison, from the lender perspective adopted by the book[14] — with an approach that would harmonize the substantive rules governing rights in indirectly held securities. To be effective, each approach must address the problem that intermediary risk undermines the absolute assurance needed by lenders that the collateral being pledged to them is enforceable against third parties. Such assurance requires — in the event of insolvency of either the investor, as collateral grantor, or a securities intermediary — that the lender's interest in the collateral is senior to claims of the intermediary's creditors and free from the grasp of the investor's other creditors.

Under most existing legal systems, a lender can rarely obtain this assurance today because, as discussed, it will not know, without consulting counsel in the investor's, each intermediary's, the

11. Potok refers to this approach as the "place of the relevant intermediary (PRIMA)" approach: at p. 5. This is the approach taken by the American Uniform Commercial Code, U.C.C. §8-110(b). See also *infra*, footnote 18 (discussing the Uniform Commercial Code).

12. A cynic might argue that the book's normative goal — advocating adoption of PRIMA as the universal conflict of laws rule — is superfluous, given that "[t]here seems to be widespread support for [the PRIMA] approach", and the Hague Conference itself has adopted that approach in its convention: Potok, at p. 5. I would contend, however, that even now that the Conference has finalized its convention on indirectly held securities, a book similar to this one will be helpful in persuading countries of the merit of adopting that convention.

13. Such as a legal system in which the priority of an investor's interest in securities as against a failed intermediary's creditors is ambiguous or in doubt.

14. Recall that the book focuses on intermediary risk solely from the perspective of lenders to securities investors, even though the lenders' rights in securities as collateral are derivative of the investors' rights in the collateral: *supra*, footnote 7 and accompanying text.

issuer's, and perhaps other jurisdictions, whether its pledge has the necessary priority. The transaction costs of consulting so many counsel can be prohibitive and, as discussed above,[15] may not even yield a definitive result. A conflict of laws approach can address this problem by imposing international rules to clarify which jurisdiction's substantive law is applicable.

However, a conflict of laws approach cannot, by itself, fully resolve this problem. Sometimes conflict of laws rules might point, for example, to a jurisdiction whose substantive law effectively subordinates the lender's security interest to rights of the investor's or an intermediary's creditors.[16] Sometimes there may even be uncertainty under that substantive law whether the collateral is a property right in underlying securities or merely an *in personam* claim against the intermediary.[17]

A substantive law approach, in contrast, would provide the needed assurance to the extent nations harmonize their laws to clarify that investors in indirect holding systems hold, and therefore lenders to such investors would be collateralized by, proprietary interests in securities as to which the investors have priority over intermediaries and their creditors. To attain this higher degree of certainty, international organizations such as the International Institute for the Unification of Private Law (UNIDROIT) and the United Nations Commission on International Trade Law (UNCITRAL), as well as the author of this book review,[18] are focusing on the larger question of modernizing and unifying *substantive* legal rules

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15. See *supra*, footnotes 8-9 and accompanying text.
16. See *supra*, footnote 13, and accompanying text.
17. See Schwarcz, *supra*, footnote 1, at pp. 1551-52 and 1556-57.
18. See *ibid.*, at pp. 1605-07 (analyzing the relationship between a conflict of laws and a substantive law approach, and concluding that "a conflicts of law approach cannot, by itself, fully resolve [the intermediary risk] problem" whereas a substantive law approach "would conclusively solve [the intermediary risk problem] to the extent nations harmonize their substantive laws to clarify that investors in indirect holding systems hold, and therefore lenders to such investors would be collateralized by, proprietary interests in securities as to which . . . investors . . . always have priority over . . . intermediaries . . . and their creditors"). In the United States, for example, Article 8 of the Uniform Commercial Code ("UCC") has been revised to resolve substantively the problem of intermediary risk by clarifying that investors have property rights in the securities (or interests therein) held for them by intermediaries, not merely *in personam* claims against the intermediaries. See UCC §8-503. Accordingly, these securities and interests "are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary", except in specific cases that should not pose the threat of systemic risk: UCC §8-503(a).

on indirect securities holding.[19] Potok's book does not, however, address this larger question.

The book therefore has imperfections. Nonetheless, they do not detract from its important central message: the problem of intermediary risk is real, creating costly legal uncertainties for securities markets; but by working together, governments can harmonize their laws to reduce these uncertainties.

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19. See e-mail from Harold S. Burman, U.S. Department of State, Office of Legal Adviser (Private International Law), to Steven L. Schwarcz (August 7, 2000) (summarizing an August 3, 2000 teleconference of the Global Electronic Policy Subcommittee in which there was a consensus that "it may be timely to pursue unification of substantive rules [, which] already has been suggested as a topic for UNCITRAL within its secured interest working group"); e-mail from Herbert Kronke, Secretary General of UNIDROIT, to Steven L. Schwarcz (October 10, 2000) (stating that "clearing and settlement issues (including the 'intermediary risk') are on the UNIDROIT work programme as one problem area of the item 'Transactions on Transnational Capital Markets' ").

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